

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

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3 CHAIRMAN

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5 COMMISSIONER

6 JEFF HATCH-MILLER
7 COMMISSIONER

8 KRISTIN K. MAYES
9 COMMISSIONER

10 GARY PIERCE
11 COMMISSIONER

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IN THE MATTER OF THE APPLICATION OF
GOLD CANYON SEWER COMPANY, AN
ARIZONA CORPORATION, FOR A
DETERMINATION OF THE FAIR VALUE OF
ITS UTILITY PLANT AND PROPERTY AND
FOR INCREASES IN ITS RATES AND
CHARGES FOR UTILITY SERVICE BASED
THEREON.

Docket No. SW-02519A-06-0015

25 **REHEARING REPLY BRIEF**

26 **OF THE RESIDENTIAL UTILITY CONSUMER OFFICE**

27 **MAY 22, 2008**

EXCESS CAPACITY

Considered altogether, the parties' Closing Briefs raise myriad issues on the subject of excess capacity. However, when the smoke clears what really is at issue is a difference of opinion between the Company, Staff and RUCO on the appropriate application of the ratemaking principle of "used and useful" in the context of the prudence of plant investment and plant capacity.

RUCO views the principle of "used and useful" from a ratemaking perspective. In other words, capacity beyond what is necessary to provide service to the existing customer base is excess capacity. This is a simple, straight forward concept. Likewise, the application of this concept in this case is straight forward. Based on the Company's records which are not in dispute, at the end of the test year – October 31, 2005 - the Company's wastewater facility had a maximum capacity of 1,900,000 gallons per day ("GPD"). A-5 at 4-5. According to the Company, at the end of 2005, the influent flow rate at the Company's Reclamation facility was 708,000 GPD, so that 62.74 percent of its maximum capacity is not necessary to meet test year demand. R-9 at 10, R-2. The Company claims that the 708,000 figure represents the influent rate flow in terms of average gallons per day. Transcript in the underlying case at 266. In terms of maximum or peak flow, the Company estimated that peak day flow for the test year was 1.1 million GPD. Transcript in the underlying case at 271. The Company's estimate is consistent with the results of Staff's engineering report, which estimated test-year monthly peak flow at 1,170,000 GPD during the month of February 2005. S-1, Schedule MSJ page 10. Based on Staff's monthly peak flow estimate for the test year, the Company had excess capacity of 730,000 GPD or 38.42 percent of its maximum capacity of 1,900,000 GPD. Stated

1 another way, 730,000 GPD was not “used and useful” from a ratemaking perspective.
2 Without question, from strictly a **ratemaking perspective** the Company had excess capacity
3 during the test year.

4 Staff and the Company have chosen to view excess capacity from an “engineering
5 perspective.” As Staff explains in its Rehearing Brief, Staff’s engineer, Marlin Scott testified
6 that a utility is expected to build and make capacity determinations with a five-year planning
7 horizon in mind. Staff Rehearing Brief at 4. Mr. Scott further testified that the Company
8 prudently projected its growth, using a five year planning period, and based on the information
9 the Company had at the time, the plant expansion was used and useful. Id. The Company
10 also relies on Mr. Scott’s engineering conclusions, as well as the opinions of its witness,
11 Charlie Hernandez (Algonquin Water Services Regional Operations Manager) and William
12 Hare, (ADEQ inspector and Compliance Officer). Company Rehearing Brief at 14-20, GC-RH-
13 6 at 1. Most of the Company and Staff’s Opening Briefs present argument to support the
14 prudence of the Company’s decision to make the improvements and use a five-year planning
15 horizon.

16 In response, RUCO has made it clear that RUCO does not disagree with the Company
17 and Staff that the Company’s decision to make the improvements was prudent at the time.
18 Rehearing Transcript at 72¹. But what was prudent at the time the Company made its decision
19 and what is used and useful at the time of the Commission’s inquiry are two completely
20 different things. In its Rehearing Brief, the Company cites to the comments of Staff’s Utilities

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22 ¹ RUCO is at a loss to understand why the Company insists that the issue before the Commission on rehearing “is still a
23 prudence determination.” Company Rehearing Brief at 19.

1 Division's Assistant Director, Steve Olea to support its conclusion that prudence and the
2 ratemaking principle of "used and useful" are synonymous. Mr. Olea commented that the
3 improvements cannot be "prudent and not be used and useful." Company Rehearing Brief at
4 18, June 26, 2007 Open Meeting Transcript at 105-106. Mr. Olea commented that Staff
5 agrees with the ROO² that RUCO cannot have it both ways, the improvements are used and
6 useful or they are not, and if the improvements are not used and useful then they are not
7 prudent according to Staff. Id.

8 With all due respect to the Commission, Staff and the Company, RUCO respectfully
9 disagrees. There is no Commission rule, ratemaking or accounting standard, or case cited in
10 this record or that RUCO could find which defines the two as the same. If the Commission is
11 bound to a prudence determination based on a point of time prior to the Company's rate
12 application as both Staff and the Company suggest, then under the Company's and Mr. Olea's
13 logic the Commission would also be bound on its determination of whether the improvements
14 are used and useful. Again, there is no authority that supports this logic.

15 Nor does it make sense to consider prudence and "used and useful" to be synonymous.
16 In most instances improvements that are deemed prudent on hindsight, in practice are also
17 used and useful at the time of inquiry, but that is not always the case. The ratemaking
18 principles of "used and useful" and prudence have "virtually nothing to do with each other."
19 Transcript at 85. The ratemaking principle of "used and useful" is not about making the
20 Company whole or unfairly taking away monies that belong to the Company's shareholders, it
21 is about who should bear the cost of the plant that was built to serve future customers and

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23 ² This portion of the ROO was adopted by the Commission in Decision No. 69664. Decision No. 69664 at 7.

1 when they should bear the costs. Id. The ratemaking principle of prudence deals with whether
2 the investment was reasonable and not dishonest or wasteful. A.A.C. R14-2-103 (A) (3) (I).
3 The Commission should not equate the ratemaking principle of “used and useful” with prudent
4 investment.

5 A Commission policy or precedent that equates the ratemaking principle of “used and
6 useful” with prudent investment would shift the entire risk of a utility’s investment to ratepayers
7 which is unfair. The subject case provides a perfect example. In or around 2004, when the
8 Company’s decisions regarding capacity were being finalized, the housing market was
9 experiencing growth. Company Rehearing Brief at 15. Since RUCO made its excess capacity
10 recommendation in June 2006, growth in the Company’s service territory has slowed down
11 dramatically. RUCO RH-1 at 4. The number of actual connections versus what the Company
12 projected over the relevant years is summarized in RUCO’s Rehearing Brief. RUCO’s
13 Rehearing Brief at 2. The Company’s actual growth at this point is much less than what the
14 Company projected and barring a significant change in the economy, it is unlikely the
15 Company will reach build out (approximately 8,600 projected service laterals)³ over the five
16 year projections estimated by Staff and the Company. Decision No. 69664 at 6. Nonetheless,
17 under Decision No. 69664, it is the current ratepayers, not the shareholders who will pay for
18 growth that may or may never occur. The Commission should determine what investment is
19 used and useful at the time of inquiry and not look back to the time the Company made its
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22 ³ As of December 2007, there were 5,420 service laterals – See Gold Canyon’s 2007 Annual Report – an excerpt of
23 which is attached to RUCO’s Rehearing Closing Brief as Exhibit A.

1 investment decisions. The Commission should not be a “rubber stamp” approving without
2 question the Company’s prior prudency determinations.

3 The Company argues that RUCO’s excess capacity recommendation would deprive the
4 Company of its “constitutional right to earn a return on prudently built plant...”⁴ Company
5 Rehearing Brief at 6. The Company has also argued that RUCO’s recommendation would
6 penalize it for its proactive and prudent investment strategies. See Company’s Closing Brief in
7 underlying case at 12. RUCO has always been sensitive to the Company’s argument. A
8 technical application of the used and useful principle as a ratemaking principle here would
9 result in a substantial decrease in ratebase recovery. A purely mathematical application of the
10 used and useful principle would be an all-or-nothing approach and could be unfair to
11 shareholders.

12 As the Company points out, quoting Commissioner Mundell, the Commissioners are
13 “more than just bean counters doing accounting calculations.” Company Rehearing Brief at
14 25. It is for this very reason that RUCO has recommended that the Commission balance both
15 the shareholder and ratepayer interests in determining how to treat excess capacity.
16 Decision No. 69664 decides the issue from an all-or-nothing perspective in favor of the
17 shareholders. Decision No. 69664 shifts the entire risk of future growth to the current
18 ratepayers. This “bean counter” approach fails to balance the ratepayer’s interests. RUCO’s
19 recommended reserve margin, as explained in RUCO’s Rehearing Brief, provides for a
20 balance that weighs both the ratepayers and shareholders interest. The remaining plant that

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22 ⁴ The Constitution does not guarantee a utility a return on its investment- the Constitution guarantees that the utility
23 shall have the opportunity to earn a return. Article 15, Section 3 of the Arizona Constitution

1 will not be recovered as a result of this case will be eligible for rate recovery if it becomes used
2 and useful in a future case. In that manner, future ratepayers will be paying for their share of
3 the investment. The Commission should adopt RUCO's more balanced excess capacity
4 recommendation.

6 **COST OF CAPITAL**

7 **A) RUCO'S APPLICATION FOR REHEARING**

8 The Company argues based on the Company's misinterpretation of comments made by
9 RUCO's counsel at a Procedural Conference that on rehearing the issue of the cost of capital
10 is limited to consideration of RUCO's hypothetical capital structure. Company Rehearing Brief
11 at 4. The Company's attempt to limit the scope of the proceeding lacks merit and should be
12 rejected.

13 A.R.S. §40-253 provides that any party to a final decision of the Commission can "apply
14 for rehearing of any matter in the action or proceeding and specified in the application for
15 rehearing...". A.R.S. §40-253 (A). RUCO filed its Application for Rehearing ("Application") of
16 Decision No. 69664 ("Application") on July 18, 2007. GC-RH-1. Throughout its Application,
17 RUCO referred to and mirrored Commissioner Mayes' Revised Proposed Amendment #3 to
18 Decision No. 69664 in explaining the cost of capital issue on which it was requesting
19 rehearing. Commissioner Mayes' Proposed Amendment would have approved RUCO's
20 proposed hypothetical capital structure, RUCO's overall weighted cost of capital of 8.54% and
21 RUCO's proposed cost of equity of 8.60%.

1 RUCO's recommended hypothetical capital structure only has relevance for purposes of
2 the rehearing if applied to RUCO's proposed cost of equity and cost of debt. Nonetheless, the
3 Company argues that since RUCO did not specifically state in its Application that it is also
4 requesting rehearing of the weighted cost of capital approved in Decision No. 69664, the
5 Commission could only apply the costs of debt and equity approved in Decision No. 69664 to
6 RUCO's proposed hypothetical capital structure. The Company points out that this approach
7 could only result in a higher weighted average cost of capital⁵. Company Rehearing at Brief
8 35-36. That fact demonstrates why the Company's misinterpretation of RUCO's Application is
9 so absurd.

10 Moreover, RUCO was clear in its Application. "By using a hypothetical capital structure
11 approach, a lower cost of capital that reflects the Company's lack of financial risk, is achieved."
12 RUCO's Application for Rehearing, GC-RH-1 at 6. By the Company's own admission, this
13 would not be the case if the hypothetical capital structure were applied to the cost of capital
14 approved in Decision No. 69664. Company Rehearing at Brief 35-36. The Application further
15 provides:

16 The water utilities used in RUCO's sample are representative of
17 the industry and, by comparison to the Company, would be considered
18 as having a higher level of financial risk (i.e. the risk associated with
19 debt repayment) because of their higher levels of debt⁶. The additional
financial risk due to debt leverage is embedded in the cost of equities
derived for those companies through the DCF analysis that RUCO
performed. Thus, the cost of equity derived in RUCO's DCF analysis is

20 ⁵ RUCO has not opposed the suggestion that the Company should be able to recover its rate case expenses associated
21 with the rehearing. But it is interesting to note that the Company is requesting an expanded interpretation of A.R.S.
22 §40-253 to accommodate its recovery of rate case expense associated with the Rehearing. Company Rehearing Brief at
23 41-42. Of course, a strict interpretation such as the Company proposes be applied to RUCO would not result in the
24 Company's rehearing expense recovery.

⁶ R-7 at 49.

1 applicable to companies that are more leveraged and, theoretically
2 speaking, riskier than a utility such as Gold Canyon, which has no debt
3 in its capital structure. In the case of a publicly traded company, like
4 those included in RUCO's proxy of companies, a company with Gold
5 Canyon's level of equity would be perceived as having extremely low to
6 no financial risk and would therefore also have a lower expected return
7 on common equity. Because of this, a 60/40 hypothetical capital
8 structure that produces a lower weighted cost of common equity is
9 appropriate for Gold Canyon⁷.

10 There is no question that RUCO's Application included rehearing of the cost of capital as
11 well as the capital structure.

12 Mr. Rigsby, in his Rehearing testimony also made it clear that RUCO was
13 requesting the Commission modify Gold Canyon's authorized capital structure and
14 weighted cost of capital.

15 Q. Please state the purpose of your rehearing testimony.

16 A. The purpose of my rehearing testimony is to explain why the
17 Commission should modify Decision No. 69664 with respect to
18 Gold Canyon's authorized capital structure **and weighted cost**
19 **of capital** that RUCO had previously recommended for Gold
20 Canyon. (Emphasis added).

21 RUCO RH-4 at 2. The balance of Mr. Rigsby's Rehearing testimony provided support for
22 RUCO's cost of equity and cost of debt recommendations. Id. at 3-35. It is unreasonable
23 to interpret RUCO's Application as applying only to the cost of capital approved by the
24 Commission in Decision No. 69664.

Finally, under A.R.S. §40-253 the Commission is not limited in scope to the
application for rehearing. A.R.S. §40-253 (C) prevents a party from raising on appeal

⁷ Id.

1 “grounds” which were not set forth in the application for rehearing. But the Commission is
2 not precluded by the statute from reconsidering any matter raised in the action or
3 proceeding. The Commission should reject this argument.

4 **B) RUCO’S RECOMMENDED COST OF CAPITAL**

5 This issue also comes down to a difference of opinion among the parties of the best
6 cost of capital methodology to apply to the facts and circumstances of this case. The
7 focus here is the best method to adjust for the Company’s financial risk. The Company
8 has an actual capital structure of 100% equity. The Company’s actual capital structure is
9 out of line with the industry average and deprives ratepayers of the benefits associated
10 with debt. RUCO’s Rehearing Brief at 9-10. RUCO advocates that a hypothetical capital
11 structure is best here because it best balances the interests of the ratepayers and the
12 shareholders. Decision No. 69664 approved the recommendation of Staff that the
13 Company’s 100% actual capital structure is appropriate here. Staff’s recommendation
14 applied a Hamada adjustment to Staff’s recommended cost of equity to adjust for risk.
15 While there is evidence in the record to support either approach, the better approach here
16 is the application of a hypothetical capital structure.

17 The Company claims that RUCO’s approach results in a “hidden adjustment” to its
18 operating expenses which would have the effect of lowering the Company’s actual return on its
19 rate base to 8.2% Company Rehearing Brief at 38 - 39. The Company claims that RUCO did
20 this without any explanation by its witnesses through the use of a hypothetical interest
21 expense. Id. The Company then posits that RUCO secretly used the hypothetical interest
22 expense to calculate the Company’s federal and state income taxes, reducing the Company’s
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income tax expense and hence its operating expenses by \$205,000. Id. The Company's sleight of hand argument is nothing more than a conspiracy theory that is completely unsupported by the evidence and completely off the mark. It is also a red herring that attempts to take the focus off the issue of the appropriate cost of capital methodology in this case.

Apparently the Company did not read the testimony of RUCO's witness in this matter. RUCO's witness, William Rigsby, explains at great length in his Rehearing testimony the effect of the interest deduction on income taxes associated with RUCO's hypothetical capital structure. RUCO RH-4 at 27 – 33. For example, Mr. Rigsby testifies:

Q. What is the impact of the interest deduction associated with your recommended hypothetical cost of debt?

A. Based on calculations performed by RUCO witness Rodney Moore, the adoption of my recommended capital structure will save Gold Canyon's customers approximately \$278,000 annually in rates. Mr. Moore discusses how average customer bills would be impacted by this change.

RUCO – RH-3 at 27. RUCO has been up-front on this issue and also has explained why the Company's argument lacks merit. The Company will be granted an appropriate level of income tax expense consistent with the result of the capital structure the Commission chooses to adopt. *Id.* at 27-28. The appropriate level of income tax expense calculated for ratemaking purposes in this case is not different than the situation where the Commission has determined a particular operating expense to be imprudent and denied it recovery in rates. *Id.* In both cases, the Commission computes income tax expense after disregarding the utility's underlying imprudent choice.

1 The positive effect to ratepayers that results from an interest deduction supports the
2 approval of a hypothetical capital structure. Decision No. 69664 was a lopsided decision which
3 heavily favored the shareholders. Ratepayers need relief in this case. On numerous
4 occasions in the past, where the shoe was on the other foot, and it was the shareholders that
5 needed relief as the result of a debt-heavy capital structure, the Commission has approved a
6 hypothetical capital structure which allowed for more equity and less debt than the utility's
7 actual capital structure⁸. In each one of those cases, it was the shareholders who benefited
8 from the smaller albeit imputed interest deduction that resulted from the hypothetical capital
9 structure⁹. The imputed interest deduction is a consequence of a hypothetical capital structure
10 and like the hypothetical capital structure proposed in this case the interest deduction results in
11 a benefit to ratepayers that offsets the inequities of Decision No. 69664. The Company's
12 "Trojan Horse" argument is a red herring and should be dismissed.

13 The additional arguments that the Company raises to distinguish the cases where the
14 Commission has approved a hypothetical capital structure are also not persuasive. The
15 Company points out the "minor" adjustments to the capital structure that the Commission made
16 in both the Southwest Gas case and the Arizona American Mohave case. Company
17 Rehearing Brief at 33. The fact that the hypothetical capital structure approved in those cases

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19 ⁸ See for example: Decision No. 68487 (Southwest Gas – Docket # G-01551A-04-0876, February 23, 2006), Decision
20 No. 69440 (Arizona American Mohave District – Docket # WS-01303A-06-0014, May 1, 2007), Decision 70011
(UNS Gas – Docket No. G-04204A-06-0463 et. al., November 27, 2007), Decision No. 58497 (Tucson Electric Power
21 Docket No. U-1933-93-006, January 13, 1994), Decision No. 56659 (Tucson Electric Power Docket No. U-1933-88-
22 280, October 24, 1989).

23 ⁹ Staff suggests that the fact that the Commission has not approved a hypothetical capital structure where there has been
24 an increase in the debt component should be controlling. Neither Staff nor the Company has presented any arguments
to show why this point should be a factor in the Commission's decision. The purpose of a hypothetical capital structure

1 contained what the Company considers minor adjustments does not make the Company's
2 choice of a hundred percent equity structure in this case more prudent. In fact, the magnitude
3 of the imprudent capital structure in this case renders the need for a hypothetical capital
4 structure even more important. The prudence of the choice and an appropriate capital
5 structure under the circumstances are the factors that the Commission must decide.

6 The Company distinguishes the TEP cases as "outliers" because of TEP's troubled
7 financial condition. In truth, Decision No. 58497 is perhaps the best precedent to support a
8 hypothetical capital structure in this case. In Decision No. 58497, the Company had a capital
9 structure that was 100% debt financed. Decision No. 58497 at 68. For different reasons, all of
10 the parties agreed that a capital structure that had an equity component was in the best
11 interests of the ratepayers and the shareholders. Id. at 68-69. The Commission-approved a
12 hypothetical capital structure of 48.83% long term debt, 1.40% short-term debt, 4.70%
13 preferred stock and 44.07% common equity. This Commission approved hypothetical capital
14 structure not only discredits the Company's "minor" adjustment argument, but it highlights the
15 fact that capital structures of 100% debt or equity are imprudent.

16 Finally, the Company refers to the Company's Black Mountain Division Decision¹⁰ and
17 claims that the Commission's failure to adopt the result from that case would be "arbitrary and
18 capricious." Company Rehearing Brief at 30. According to the Company, "there is nothing that
19 distinguishes Black Mountain from GCSC." Id. This statement exemplifies a complete
20 misunderstanding of the regulatory concept of cost of capital and capital structure. Black

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22 is to address an imprudent capital structure whether it is debt heavy as in the TEP case explained below (Decision No.
23 58497) or equity heavy.

1 Mountain and Gold Canyon are two different operating districts. Each district has its own rate
2 base. Each district generates its own revenues separate from the other. Each district has its
3 own operating expenses separate from the other. Each district faces different risks. Likewise
4 each district has its own cost of capital – using the same capital structures (i.e. 100% equity)
5 the Commission did not authorize the same cost of equity or the same overall weighted cost of
6 capital for Black Mountain and Gold Canyon. In short, all these factors go into a decision of an
7 appropriate capital structure. Disregarding these factors, as the Company seems to be
8 suggesting would result in an “arbitrary and capricious” decision.

9 The many factors described above that distinguish Black Mountain from Gold Canyon
10 also explain why RUCO, contrary to Staff’s assertions, is not suggesting that the Commission
11 acted improperly in the Rio Rico and Goodman cases. Staff Rehearing Brief at 6.

12

13 **CONCLUSION**

14 For the foregoing reasons, the Commission should reconsider Decision No. 69664
15 and approve RUCO’s excess capacity and cost of capital recommendations.

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17 RESPECTFULLY SUBMITTED this 22th day of May 2008.

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20 _____
Daniel Pozefsky
Attorney

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22 _____
23 ¹⁰ Decision No. 69164 (Docket No. SW-02361A-05-0657, December 5, 2006).

1 AN ORIGINAL AND THIRTEEN COPIES
2 of the foregoing filed this 22nd day
3 of May 2008 with:

4 Docket Control
5 Arizona Corporation Commission
6 1200 West Washington
7 Phoenix, Arizona 85007

8 COPIES of the foregoing hand delivered/
9 mailed this 22nd day of May 2008 to:

10 Dwight Nodes
11 Administrative Law Judge
12 Hearing Division
13 Arizona Corporation Commission
14 1200 West Washington
15 Phoenix, Arizona 85007

16 Janice Allward, Chief Counsel
17 Legal Division
18 Arizona Corporation Commission
19 1200 West Washington
20 Phoenix, Arizona 85007

21 Ernest Johnson, Director
22 Utilities Division
23 Arizona Corporation Commission
24 1200 West Washington
Phoenix, Arizona 85007

Jay L. Shapiro
Fennemore Craig, P.C.
3003 N. Central Avenue, Suite 2600
Phoenix, Arizona 85012

Greg Sorenson
Gold Canyon Sewer Company
12725 W. Indian School Road
Suite D-101
Avondale, AZ 85323

Andy Kurtz
Mountainbrook Village at Gold Canyon
Ranch Association
5674 S. Marble Drive
Gold Canyon, AZ 85218

Mark A. Tucker, Attorney At Law
Mark A. Tucker, P.C.
2650 E. Southern Avenue
Mesa, AZ 85204

By _____
Cheryl Fraulob